



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
Internal Revenue Service
Exempt Organization Examination Division
575 Pennsylvania Street, MS 750
Indianapolis, IN 46204

Release Number: **200836045**

Release Date: 9/5/08

Date: October 23, 2007

UIL Code: 501.03-01

Legend

ORG = Organization name

ADDRESS

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Jason Alexander, Revenue Agent
Exempt Organization Examination

Enclosures:
Publication 892
Publication 3498
Report of Examination

Form 886A	Department of the Treasury - Internal Revenue Service Explanation of Items	Schedule No. or Exhibit
Name of Taxpayer ORG		Year/Period Ended December 31 20XX, 20XX, 20XX

LEGEND

ORG = Organization name XX = Date XYZ = State City = city
BM-1, BM-2, BM-3, BM-4, BM-5 = 1ST, 2ND, 3RD, 4TH, & 5TH board members

Issues

Is ORG operated exclusively for an exempt purpose under §501(c)(3)?

Facts

ORG is currently exempt under §501(c)(3) and organized as a non-profit corporation in the State of XYZ.

The board of directors has never held a meeting and consists of 5 individuals: BM-1, BM-2, BM-3, BM-4, and BM-5. BM-2 and BM-1 are husband and wife, BM-3 is the mother of BM-1 and an employee of ORG. BM-1 and BM-2 stated that they made all decisions on the operations without board input or knowledge.

During the period 20XX through 20XX, BM-2 and BM-1 operated ORG as a personally owned business. They used the assets and income of ORG to pay personal expenses and have stated that they thought that they were the owners and entitled to the proceeds.

During 20XX, BM-2 and BM-1 did not take a salary or report other income from ORG. During 20XX and 20XX, they took a salary and received a W-2 but did not fully report other cash taken or expenses paid by ORG. Personal expenses paid by ORG included insurance, utilities on the personal home, cable at the personal home, the purchase of vehicles titled to the individual, repairs on the vehicles, cash advances at a casino, cashed checks at a local gas station, and food purchases at times and in quantities for personal use. Some of the payments can be traced to a specific individual and other payments were for their joint benefit. None of the payments were approved by the board of directors or reported as income. Some of the expenditures were listed as a loan on the books but no board approval existed, no loan documents existed, no interest was accrued, and no payments were made.

In periods prior to and including 20XX, a GL account labeled "Owner's Draw" included expenses and amounts paid by ORG on behalf of BM-2 and BM-1. In addition several assets on the books were in fact in the name of BM-2 and BM-1 and included personal use vehicles and other assets not used in the exempt activity. This initial amount was not authorized by the board and was not reported as income, no loan documents exist and no payments were made. In later years the GL account was labeled "Due to/from BM-1".

The starting balance was \$ after adjusting for assets listed on the books and purchased by ORG but titled and owned by BM-2 and BM-1. Although the prior periods were not

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audited, the balance sheet as of January 1, 20XX was audited and the corrections made relate to verified assets and the liability balance as of that date.

In 20XX when BM-2 and BM-1 were not taking a salary it increased by \$ this amounted to 30.6% of the total income for the year. During 20XX and 20XX the amount increased by \$ and \$ just over 8% of the income each year, in addition to the reported wages paid in those years. There is no reasonable plan to pay this debt and no interest has been accrued. The debt principle accounted for over 96% of the total assets at the end of 20XX.

	BM-1	BM-2	Joint	Total Amount	Income	% income
Starting Balance						
20XX						
20XX						
20XX						
Totals						

Total
Assets
Loan % of
Assets

Mutual amounts include any amounts that cannot be traced by signature to a specific individual, amounts used to purchase goods titled to both individuals, and expenses for the joint marital home. BM-2 and BM-1 were married and living together in the marital home for the entire period up through the date of the audit April 27, 20XX and shared in the benefit from the joint maintenance.

Interest on the amounts taken for personal use should apply at a fair market rate. Since no investigation of credit was made and no formal loan exists, the prime rate is used. The prime rate on the last day of the year is used for the stream of payments received and for the outstanding balance due from prior periods.

Interest due through October 31, 20XX				
	Rate	BM-1	BM-2	Joint
12/31/20XX	4.25%			
12/31/20XX	4.00%			
12/31/20XX	5.25%			
12/31/20XX	7.25%			
Total				

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BM-2 and BM-1 were employed full time at ORG for 20XX, 20XX, and 20XX. During 20XX they had no salary, for 20XX and 20XX a reasonable salary was paid and reported on Form W-2 for each even though no board authorization was made.

ORG provides daycare for the community of City, XYZ. Approximately 70% of the area is below the state poverty line and almost all of the organization's income is from XYZ state payments for children with parents on public assistance.

BM-2 and BM-1 have submitted a statement that they believed ORG was their personal business and they had a right to the proceeds.

Law

An organization exempt from tax under §501(c)(3) must be exclusively engaged in an exempt purpose and "no part of the net earnings of which inures to the benefit of any private shareholder or individual".

Revenue Regulation §1.501(c)(3)-1(c)(2) states that if the net earnings inure to a private shareholder or individual the organization is not exclusively engaged in an exempt purpose.

Founding Church of Scientology v. U.S., 188 Ct.Cl. 490, 412 F.2d 1197, Ct.Cl. 1969 – clearly states that the prohibition on inurement is absolute, that undocumented loans and payments to or for the benefit of private shareholders is inurement, and that reasonable compensation is not a defense or excuse for unauthorized or irregular transactions.

Government Position

ORG was operated for the benefit of BM-2 and BM-1. BM-2 and BM-1 had control over ORG and utilized that control for financial gain that was not authorized by the board or reported as income.

As such, ORG does not qualify as exempt under §501(c)(3) and should submit a Form 1120 starting with the tax year beginning January 1, 20XX. Furthermore the excess benefit received by BM-2 and BM-1 must be corrected by repayment of the principle and interest. Interest charged is based on the prime rate in effect on the closing day of the tax year that the balance was outstanding. The joint expenses including the balance from prior periods with the interest rate from December 31, 20XX are treated as joint and several liabilities. Interest shown is current as of October 31, 20XX.

Total amount for correction	
BM-1	
BM-2	

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Joint and Several	
Total Due	

In addition, any payments made in 20XX and 20XX must be corrected as well. However, at the time of the audit, returns were not complete for the year 20XX and 20XX is not yet closed.

Taxpayer Position

The taxpayer position is not known at this time and is to be provided.

Conclusion

ORG is not operated exclusively for an exempt purpose and is revoked effective January 1, 20XX. Form 1120 is required for the tax year 20XX and all subsequent years. Correction for excess benefit must be made for the years 20XX, 20XX, and 20XX in the total amount of \$ as of October 31, 20XX.

**Department of the Treasury
Internal Revenue Service
Exempt Organization Examination Division
575 Pennsylvania Street, MS 750
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LEGEND

ORG = Organization name Address = address

UIL: 501.03-01

ORG
ADDRESS

Person to Contact:
Identification Number:
Contact Telephone Number:
In Reply Refer to: TE/GE Review Staff
EIN:

LAST DATE FOR FILING A PETITION
WITH THE TAX COURT: _____

Dear

This is a Final Adverse Determination letter which revokes ORG tax exempt status under section 501(c)(3) of the Internal Revenue Code. The Internal Revenue Service's recognition of your organization as an organization described in section 501(c)(3) is hereby revoked effective from January 1, 20XX.

We have made this determination for the following reasons:

Organizations exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code are required to operate exclusively for charitable, educational or other exempt purposes. Organizations are not operated exclusively for exempt purposes if the net earnings of the organization inure in whole or in part to the benefit of private shareholders or individuals of the organization. See Treas. Reg. 1.501(c)(3)-1(c)(2)

During 20XX, 20XX and 20XX, we have determined that your net earnings inured to the benefit of your founders by regularly paying personal expenses and by funding no-interest personal loans not contemporaneously recorded as expenditures for salary or compensation and without authorization by the board of directors. The funds inuring to your founders were substantial in comparison to your total expenditures and were multiple or repeated over a pattern of years. You have not implemented safeguards to prevent a recurrence of funds inuring to your founder. As such, you have not operated exclusively for exempt purposes and have operated for the benefit of private interests of individuals in contravention of the requirements of 1.501(c)(3)-1(d)(1)(ii).

Contributions to your organization are no longer deductible under section 170 of the Internal Revenue Code.

You are required to file Federal income tax returns on Form 1120. These returns should be filed with the appropriate Service Center for the year ending December 31, 20XX, and for all years thereafter.

Processing of income tax returns and assessment of any taxes due will not be delayed should a petition for declaratory judgment be filed under section 7428 of the Internal Revenue Code.

If you decide to contest this determination in court, you must initiate a suit for declaratory judgment in the United States Tax Court, the United States Claim Court or the District Court of the United States for the District of Columbia before the 91st day after the date this determination was mailed to you. Contact the clerk of the appropriate court for the rules for initiating suits for declaratory judgment.

You also have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and telephone number are shown above since this person can access your tax information and can help you get answers. You can call and ask for Taxpayer Advocate assistance. Or you can contact the Taxpayer Advocate from the site where the tax deficiency was determined by calling or writing to: Internal Revenue Service, Taxpayer Advocates Office.

Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the United States Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling.

We will notify the appropriate State Officials of this action, as required by section 6104(c) of the Internal Revenue Code.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

Marsha A. Ramirez
Director, EO Examinations